The Implication of a Term of Good Faith in Commercial Leases

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Much has been written in the past decade on the subject of the implication of a term of good faith in contracts in Australia, particularly since the judgment of Priestley JA in **Renard Constructions (ME) Pty Ltd v Minister for Public Works** *(1992) 26 NSWLR 234.*

Except for an early article by Rachael Mulheron; "Good Faith and Commercial Leases: New Opportunities for the Tenant" (1996) 4 APLJ 223, very little else has been written with respect to the possible application of the doctrine to commercial leases.

With the advent of two later New South Wales Supreme Court decisions **Alcatel Australia Ltd v Scarcella** *(1998) 44 NSWLR 349 and, more recently,* **Advance Fitness v Bondi Diggers** *[1999] NSWSC 264, the question of the application of the doctrine in the commercial leasing context has been examined.*

This article briefly considers the nature and substance of the doctrine against the background of the relationship of lessor and lessee and examines in some depth the Australian decisions on commercial leases where it has been sought, unsuccessfully, to apply the doctrine.

The article concludes by suggesting that as a standard commercial lease usually covers the field of agreement between lessor and lessee and as a lessee has a high degree of statutory protection derived from equitable principles, there may be little room for the operation of the doctrine in this legal environment.

Context

During the past decade in Australia there has been much written upon whether or not an obligation of good faith and fair dealing can be implied in commercial contracts in Australia. Much of the literature[1] arose from a judgment of Priestley JA in *Renard*

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1 M Branson, "Doctrine of Implied Terms" (1996) 10 Journal of Contract Law 94; GJ Tolhurst and JW Carter, "The New Law on Implied Terms" (1996) 11 Journal of Contract Law 76; JW Carter and GJ Tolhurst, "Implied Terms: Refining the New Law" (1997) 12 Journal of Contract Law 152; Andrew Phang "Tenants, Implied Terms and Fairness in the Law of Contract" (1998) 13 Journal of Contract Law 126; JM Paterson, "Terms Implied and Fact: The Basis for Implication" (1998) 13 Journal of Contract Law 103; Elisabeth Peden, " 'Co-operation' in English Contract Law – To Construe or Imply?" (2000) 16 Journal of Contract Law 56; Elisabeth Peden, "Incorporating Terms of Good Faith in Contract Law in Australia" (2001) 23 Sydney Law Review 222.

Constructions (ME) Pty Ltd v Minister for Public Works[2] who held that a contractual power in a building contract, which permitted the principal to take over the builders work, was required to be exercised reasonably, this requirement being as a result of the implication of a term that the principal should act in good faith when exercising discretions under the contract.[3] Although there was some early judicial deprecation of the application of this principle,[4] it has since has been applied in several cases with approval, among these being *Hughes Bros Pty Ltd v Trustees of the Roman Catholic Church for the Archdiocese of Sydney*[5] and *Hughes Aircraft Systems International v Air Services Australia*.[6] However, there is much controversy as to how the courts, and in what circumstances, are to impose this obligation. This concerns the matter whether the term is to be incorporated by implication in the conventional way,[7] or whether it should be used as a canon of construction of the particular contract being adjudicated upon.[8]

It is not intended here to review the wealth of literature nor all the cases upon the question of application of a "good faith" term. Instead, it is proposed to consider how this doctrine has been applied in cases relating to commercial leases. However, before doing so, one should briefly set the scene appropriately by considering the nature of a commercial lease as a certain form of contract.

The Commercial Lease as a Contract

It is trite law that a lease has two functions. The first is to grant the lessee an estate or interest in the land leased. The second is to embody the arrangements between the lessor and lessee in a contractual form. However, there has been much litigation over the extent to which contractual principles apply to leases, given the dichotomy in functions. The interaction of these two functions can become irrational in certain circumstances, for

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2 (1992) 26 NSW LR 234.
3 Ibid at 263.
4 *Service Station Association Ltd v Berg Bennett & Associates Ltd* (1993) 45 FCR 84 at 96 per Gummow J.
5 (1993) 31 NSW LR 91-93.
6 (1997) 146 ALR 1 at 36 per Finn J.
7 *BP Refinery (Western Port) Pty Ltd v President, Councillors and Rate Payers of the Shire of Hastings* (1977) 180 CLR 266.
8 Elisabeth Peden, "Incorporating Terms of Good Faith in Contract Law in Australia", op. cit., at 230-231.

example, where the leased premises are destroyed during the currency of the lease. The destruction of the matter of a contract not conveying an interest in land would usually mean that the contract would be frustrated. In the case of a lease, grant of the interest in land would not be affected by destruction of a physical subject matter of the lease and the liability to pay rent therefore would be held to continue.[9] This view has been followed in Australia.[10] However, in 1981 the House of Lords in *National Carriers Ltd v Panalpina (Northern) Ltd*[11] reconsidered the principle in the light of commercial reality. Without descent into detail, the court said that in circumstances where the doctrine of frustration might apply to an ordinary contract, the court might consider whether a term might be implied into a lease which would determine in those circumstances and release the lessee from any liability under the lease from that time.[12] Regrettably, there has been no opportunity since for an appellate court to directly consider this question in Australia.

In 1906, the High Court in *Buchanan v Byrnes*[13] treated a lease as a contract holding that a lessor had a right to damages for lost rent, maintenance costs rates and taxes payable by the lessee under the lease after the lessee had abandoned the premises and the lessor had re-entered. More recently, the High Court has held directly that the contractual principle of repudiation applies to leases,[14] and, more specifically, the same court in *Progressive Mailing House Pty Ltd v Tabali*[15] applied the law of repudiation in contract to the conduct of a lessee guilty of the breach of numerous obligations a the lease. These rules have since been applied on a number of occasions.[16] Other contractual characteristics have been ascribed to leases such as the duty of a party to mitigate loss,[17] and the law relating to characterisation of terms as essential and non-essential.[18] Again, there is

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9 *Matthey v Curling* [1922] 2 AC 180 at 237.

10 *Firth v Halloran* (1926) 38 CLR 261 at 269 per Isaacs J; *Re Equity Trustees Executors and Agency Co Ltd and Considine's Contract* [1932] VLR 137 at 141-142 per Cussens ACJ.

11 [1981] AC 675.

12 Ibid at 692 per Lord Hailsham, at 697 per Lord Wilberforce, at 718 per Lord Roskill.

13 (1906) 3 CLR 704 at 713 per Griffith CJ.

14 *Shevill v Builders' Licensing Board* (1982) 149 CLR 620-625.

15 (1985) 157 CLR 17 at 30, 36.

16 Eg, see, *Wood Factory Pty Ltd v Kiritos Pty Ltd* [1985] 2 NSWLR 105 at 145; *Ripka Pty Ltd v Maggiore Bakeries Pty Ltd* [1984] VR 629 at 635.

17 *Vickers & Vickers v Stichtentoth Investment Pty Ltd* (1989) 52 SASR 90 at 100 per Bollen J; *Jones v Edwards* (1994) 3 TASR 350.

18 *Gallic Pty Ltd v Cynayne Pty Ltd* (1986) 83 FLR 31 at 37, 38.

adequate literature on this subject which gives further examples.[19] For the purposes of this exposition, it will be assumed that a lease can for most purposes be treated as a contract.

The Relationship of Lessor and Lessee

At all levels, it would appear that the core relationship of lessor and lessee is simply that of one contracting party and another. Regardless of the duties imposed upon both parties by a lease, all things being equal, a lessor does not owe a fiduciary duty to a lessee merely arising out or the existence of the relationship. The point is well illustrated by the case of *Peyser v Northpoint Properties Ltd*[20] where a lease made provision that rent could be adjusted if the lessor's outgoings exceeded outgoings at an earlier period. The lessor claimed an increase and the lessee indicated a desire to inspect relevant records of the lessor but was refused. The lessee sought a declaration of an entitlement to inspection. There was no express term in the lease relating to inspection. The lessee argued amongst other things, that there was a fiduciary relationship between himself and the lessor with respect to the disclosure of records and this obligation was based on an alleged duty to account under the lease. The decisions relied upon to support this claim were based upon the law of principal and agent,[21] where there is a clear obligation to account. In the same decision, there was an ingenious attempt by the lessee to claim some proprietary interest in the records held by the lessor based on the decision of *Price v Harrison.*[22] That case was an action by a lessor against a lessee for monies payable under an agreement for lease, the lessee having obtained an order to inspect certain letters upon which it was surmised the lessor intended to rely for the purpose for establishing the agreement. There was a suggestion that the other party in possession of the letters was holding it as "a

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19 Jack Effron, "The Contractualisation of the Law of Leasehold: Pitfalls and Opportunities" (1988) 14 Monash University Law Review 83; Duncan, "Of Straws and Camel's Backs – Fundamental Breach of Lease" (1986) 2 Queensland Institute of Technology Law Journal 31; Redfern, "Mitigation of Loss by a Landlord where a Tenant Repudiates the Lease" (1994) 2 Australian Property Law Journal 175; Boge, "Repudiation of Leases" (1996) 26 Queensland Law Society Journal 125; Debenham, "Contract Law and Real Property Leases" (1995) 3 Australian Property Law Journal 52.

20 (1982) 3 BPR [19172], 9177.

21 *Makepeace v Rogers* (1865) 34 LJ Ch 396; *Hardwicke v Vernon* (1808) 14 Ves Jun 503; 33 ER 614.

22 (1860) 8 CBNS 617; 141 ER 1308.

trustee" for the other and that the party requiring the documents had "an interest" in them.[23] However, Rath J in *Peyser v Northpoint Properties Ltd*[24] could not make out any proprietary right of a lessee to a document held by the lessor, the only obligation of the lessor being to deliver it to the lessee in consequence of the exercise of a power of a court to order discovery and inspection.[25]

Nor is a lease in the nature of a joint venture,[26] or a partnership.[27] In both those instances, fiduciary obligations are owed one to the other and in consequence, the parties owe each other a duty of good faith. At its highest, the fiduciary must completely subordinate himself or herself to the interests of the beneficiary.[28] This is not the hallmark of an ordinary relationship of lessor and lessee. However, the more imprecise duty of good faith, or as it is sometimes known, a duty of fair dealing, does not require the subordination of interests of one party to another but permits self interest in the context of acting fairly.[29] The breach of the contractual duty of good faith results only in damages where as breach of the fiduciary duty may give rise to more specific remedies, such as account or the imposition of a constructive trust.[30]

Examples of the Exercise of Unfettered Discretion by the Lessor

There have been some instances of cases of commercial leases where the lessor has been expressly given an unfettered discretion to make a decision, which would have some bearing on the liability of the lessee. This has largely related to the selection or approval of insurance of the demised premises. For example, in *Viscount Tredegar v Hardwood*[31] a 99-year lease contained a covenant by the lessee to insure against fire in the joint names

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23 (1860) 141 ER 1308 at 1314 per Earle CJ.

24 (1982) 3 BPR [97172].

25 Ibid at 9182.

26 *United Dominions Corporation Ltd v Brian Pty Ltd* (1985) 157 CLR 1 at 10.

27 *Canny Gabriel Castle Jackson Advertising Pty Ltd v Volume Sales (Finance) Pty Ltd* (1974) 131 CLR 321.

28 PD Finn, "Contract and the Fiduciary Principle" (1989) 12 University of New South Wales Law Journal 76 at 84.

29 S Ongley, "Joint Ventures and Fiduciary Obligations" (1992) 22 Victoria University Law Review 265 at 267; PD Finn, "The Fiduciary Principle" in TG Youdan (ed.), *Equity, Fiduciaries and Trusts* (Carswell, Toronto, 1989) at 27.

30 *Hospital Products Ltd v United States Surgical Corporation* (1984) 154 CLR 41 at 113-114 per Mason J (as he then was).

31 [1929] AC 72.

of lessor and lessee "in the Law Fire Office or in some other responsible insurance office to be approved by the lessor". The lessee, as an assignee of the lease, failed to continue the policy at the Law Fire Office and took out a policy with another company whom the lessor refused to approved on the basis that as the Fire's premises were part of a large number of other houses on the same estate, it was more appropriate that all the properties should be insured with the same office. The lessor eventually brought proceedings against the lessee to forfeit the lease on the basis of a breach of this covenant in failing to obtain approval. The question for the House of Lords was whether or not the lessor had an absolute right to withhold approval for any reason. In giving the judgment of the House, Lord Shaw of Dunfermline distinguished the instant case from that of withholding an approval for an assignment or a subletting on the grounds that the right to refuse approval in the latter case usually would expressly not be withheld unreasonably. In this case, there was no such restriction or condition upon the right of approval or disapproval. In upsetting the judgment of the Court of Appeal, Lord Shaw would not import an implication into the lease that the consent of the lessor to any responsible insurance office selected by the lessee not be unreasonably withheld, nor an implication that the lessor furnish a justification for his refusal.[32] Both Lord Shaw and Lord Phillimore held that the lessor was acting perfectly reasonably in refusing approval to the lessor's preferred insurer.[33]

A very similar situation arose again in the decision of *Bandar Property Holdings Ltd v JS Darwen (Successors) Ltd*.[34] Under the terms of a 21-year lease, the lessor agreed to keep the demised premises insured at some insurance offices of repute or at Lloyds. The lessees expressly agreed to pay the lessor the amount of the premiums involved. The lessor placed insurance in accordance with that clause but at a higher premium than they might have done had they acceded to the lessee's direction to place insurance through another firm of Lloyds Brokers. The question for the court was whether the lessor had an unfettered discretion to place the insurance as they saw fit notwithstanding that it imposed a heavier financial burden on the lessee. In other words, would the court imply a

32 Ibid at 80.
33 Ibid at 81.
34 [1968] 2 ALL ER 305.

term that the lessor should place the insurance so as not to impose that burden. Roskill J, implying the "business efficacy" rule, held that the court would not imply a term in these circumstances as no implication was necessary for the bargain to work.[35] The lessee had argued firstly, that it was quite unreasonable to read the covenant free from all restrictions in favour of the lessee and, by implication, whilst the lessor was not bound of necessity to obtain the cheapest rate of insurance, the lessor was bound to look at all the circumstances to avoid an unnecessarily heavy burden on the lessee.[36]

In neither case is the doctrine of the implication of a term of good faith mentioned. However, it is submitted that these would be circumstances in which the lessee may have argued that such an implication might be appropriate. In the first case, the court rationalised the decision of the lessor on the basis of facilitating the management of insurance cover for the demised premises as part of a cover for a number of other premises and, in the second case, the court justified its refusal to accede to the lessee's request of implied term, by applying the business efficacy rule.

In the light of more recent cases to be considered later in this article, there is no certainty that a term would have been implied had these questions arisen in the context of a current commercial lease.[37]

The business efficacy rule is still a touchstone for the implication of terms into a commercial agreements, and in the absence of dishonesty (of which there was no evidence in either of these cases) a lessee might well remain disappointed if these situations had arisen today.

This is, to some extent, borne out by the decision in *VL Credits Pty Ltd v Switzerland General Insurance Co Ld (No. 2*)[38] where a lease provided that in the event of the demised premises being totally or so substantially destroyed that reinstatement shall in

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35 Ibid at 309.
36 Ibid at 308.
37 Ignoring the question of the question of third line forcing.
38 [1991] 2 VR 311.

the opinion of the lessor be unjustified, the lessor or lessee may within thirty days elect to determine the lease. Upon the building being destroyed by a fire, the lessor elected to terminate the lease. The lessee argued that the lessor's opinion should have been reasonably formed that the lessor had unreasonably concluded that reinstatement was unjustified. This argument was not accepted by the court and, in rejecting it, Ormiston J said that "at (its) highest, the only qualification that should be implied into the expression is that the opinion (of the lessor) should be honestly held".[39]

These decisions clearly indicate that, historically, the courts have been loathed to imply that a lessor or lessee in commercial leases be required to exercise a discretion in a reasonable manner or in good faith and, except for those matters governed by statute, the lessor can unreasonably withhold consent to most requests.[40]

Substance of the Terms Imposing Obligation of Good Faith

There have been a number of attempts judicially to explain the substance of an implied term of good faith. If the substance is understood, the circumstances in which it may be implied can be more easily identified. Priestley JA in *Renard Constructions (NE) Pty Ltd v Minister for Public Works*[41] commented that:

> "…People generally, including judges and other lawyers, from all strands of the community, have grown used to the courts applying standards of fairness to contract which are wholly consistent with the existence in all contracts of a duty upon parties of good faith and fair dealing in its performance. In my view, this is, in these days, the expected standard, and anything less is contrary to prevailing community expectations".[42]

As Elisabeth Peden acknowledges in her article, there has been much academic comment on the possible meaning of the expression "good faith" and few judges have been brave enough to postulate the possible content of the obligations.[43] Some of the relevant

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39 Ibid at 315.

40 Rachael Mulheron, "Good Faith and Commercial Leases: New Opportunities for the Tenant" (1996) Australian Property Law Journal 223 at 233.

41 (1992) 26 NSWLR 234.

42 Ibid at 268.

43 Elisabeth Peden, "Incorporating Terms of Good Faith in Contract Law in Australia", op. cit., at 236.

decisions concern express agreements "to negotiate in good faith" which expression has generally been considered to have legal meaning. For example, in *Con Kallergis Pty Ltd trading as Sunlighting Australasia Pty Ltd v Calshonie Pty Ltd (formerly CW Norris Pty Ltd),*[44] a question arose as to whether an agreement for valuation of variations in a building contract was uncertain or incomplete on the ground that the agreement provided that the price of the work was to be negotiated by one party to the contract with a third party. The argument proceeded on the assumption that the contracting party's obligation to negotiate, may probably be seen as an obligation to negotiate in good faith or to do so honestly and reasonably. The court made the following remarks, in obiter:

> "It was submitted… that even if the obligation undertaken … was to negotiate in good faith… the obligation was still too uncertain to admit enforcement. Although there may be difficult questions of fact and degree about whether evidence of particular conduct reveals lack of good faith or lack of honesty or reasonableness, the obligation to act in good faith or honestly or reasonably is an obligation that is certain."[45]

In this instance, the court aligned good faith with honesty. Parties have always been under an obligation to act honestly in the performance of a contract.[46] In *Hughes Aircraft Systems International v Air Services,*[47] Finn J, in obiter, describes "fair dealing which seems to be a synonym for good faith as a major (if not openly articulated) organising idea in Australian law… and one (he would consider) to be an implied duty that expresses a generalisation of universal application being the standard of conduct which all contracting parties are to be expected to adhere throughout the lives of their contracts".[48] Einstein J, in *Aiton v Transfield,*[49] after an exhaustive investigation as to the meaning of the obligation to negotiate or perform in good faith, found that the content of any good faith requirement depended upon the context (statutory or otherwise) and the particular factual circumstances in which the obligation might arise.[50] In that particular case, there was an express obligation to "negotiate or mediate in good faith". His Honour

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44 (1998) 14 BCL 201.
45 Ibid at 211-212.
46 *Meehan v Jones (*1982) 149 CLR 571 at 589 per Mason J (as he then was).
47 (1997) 146 ALR 1.
48 Ibid at 36-37.
49 (1999) 153 FLR 236.
50 Ibid at 268.

expressed the content of the obligation in that circumstance for a party to undertake the process with an open mind, with a willingness to consider options to resolve the dispute without obliging the party to act in the interests of the other party or to act otherwise than in self interest.[51]

Stapleton, in an article entitled "*Good Faith in Private Law*"[52] opined that to act in good faith required that a person not act dishonestly, act with sincerity and not deliberately exploit a position of dominance over another. Stapleton also drew a distinction between good faith and reasonableness, the standard of reasonable behaviour, he says, being more demanding than a requirement of good faith.[53] In another context, a term of a contract that required a party to act in good faith and fairly was held to impose an obligation upon that party not to act capriciously, and provided the party exercising the power acted reasonably in normal circumstances, the duty to act fairly and in good faith would ordinarily be satisfied.[54]

There is nothing new in this in the contractual context. In *Secured Income Real Estate (Australia) Ltd v St Martins Investments Pty Ltd,*[55] the High Court, in recognising the implication of a duty to co-operate in the doing of acts necessary for the performance of a contract by the parties, had to consider whether one party had acted capriciously or arbitrarily in its performance of the contract. Speaking of the meaning of the expression "arbitrarily" (in the context of a refusal of consent to an assignment of a lease) Mason J (as he then was) said:

> "I am inclined to agree that the expressions "unreasonably", "wholly unreasonably" and "without reasonable cause", practically mean the same thing though I should prefer to say that "arbitrarily" connotes "unreasonably" in the sense that what was done was done "without reasonable cause". In these

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51 Ibid at 268.

52 [1999] Current Legal Problems 1.

53 Ibid at 5-7.

54 *Gary Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* (1999) ATPR 41-703, 43,008 at 43,014 per Finkelstein J.

55 (1979) 144 CLR 596.

> circumstances, I doubt whether "capriciously" adds anything except perhaps to direct attention to the motivation of the respondent."[56]

Therefore, can this be said to be the substance of the obligation to act in good faith, express or implied? It might be concluded that such an obligation would import notions of all the elements of reasonableness, honesty, fair play, lack of caprice and lack of arbitrariness. To what extent are the motives of the party whose actions are the subject of an alleged breach of the implied obligation of good faith relevant?

It is little wonder, then, that the parliament has directed the courts in determining whether a corporation has engaged in unconscionable conduct, to have regard to a number of matters, one of which the extent to which a party has acted in good faith.[57] There is a clear implication, of a community expectation exemplified in this legislation that all contracting parties to which the legislation applies will, in their dealings with other parties, act with probity and, to some extent fairly.

However, to what extent this doctrine might impact on the relationship of commercial lessor and lessee must, it is submitted, depend very much upon the particular circumstances in which it may be desired that it operate and the express terms of the lease where such an obligation is to be implied.

Circumstances in Which Implication May be Made

It is conceded that very few commercial leases would contain an express term that the parties must act in good faith. Therefore, in the case of a commercial lease, the term would generally have to be implied. As a rule, a term of a contract will not be implied unless it is necessary to give business efficacy to a contract, unless it is reasonable and equitable, and capable of clear expression without contradicting any express term.[58] Whilst the obligation, as an implied obligation, might be engrafted upon the exercise of

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56 Ibid at 609.

57 Section 51AC(3)(k) *Trade Practices Act* 1974.

58 *BP Refinery (Westernport) Pty Ltd v President, Councillors and Rate Payers of the Shire of Hastings* (1977) 180 CLR 266; *Codelfa Construction Pty Ltd v State Rail Authority of New South Wales* (1982) 149 CLR 337 at 347.

any power under a contract, it has found a most comfortable residence as qualifying the exercise of a termination power, but not so as to act as a restriction on that power, particularly if it is in general terms.[59] The case law also suggests a more ready implication in standard form contracts containing a power of termination.[60] Commercial leases are not standard form contracts. The examples of the implication afforded an opportunity in non-standard forms of relationship are more broadly based. It is appropriate that some of the circumstances in which there has been an attempt, either successfully or unsuccessfully, to imply such a term into a commercial lease, be exemplified.

Examples of Implication of Terms of Good Faith in Commercial Leases

(a) Assignment (or subletting) of lease

Assignments of commercial leases are already regulated in most states[61] and the assignment of retail shop leases are even more so regulated.[62] There are very few examples of the application of the principle in this area of leasing. In the one significant example, *Australian Mutual Provident Society v 400 St Kilda Road Pty Ltd,*[63] a commercial lease lawfully excluded the provisions of s 144 of the *Property Law Act* 1958 (Vic) permitting a lessor to unreasonably withhold consent to an assignment. The lessor withheld its consent to a lessee subletting portions of and effecting improvements to a building in order to force the lessee to vary the lease by making its terms more favourable rent wise to a prospective purchaser of the property. The lessor also claimed that the lessee had sublet parts of the premises without consent, carried out improvements without consent and used the premises outside the permitted use. The lessee disputed these claims and alleged that it was a

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59 *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd* (1999) ATPR 41-703, 43,008 at 43, 014 per Finkelstein J.

60 *Burger King Corp v Hungry Jack's Pty Ltd* (unreported, Supreme Court of New South Wales, Court of Appeal, 21 June 2001, Sheller, Beazley and Stein JJA) at [163].

61 *Conveyancing Act* 1919 (NSW) s 133B(1)(a); *Property Law Act* 1958 (Vic) s 144(1); *Property Law Act* 1974 (Qld) s 121(1)(a); *Property Law Act* 1969 (WA) s 80.

62 *Retail Leases Act* 1994 (NSW) s 43; *Retail Tenancies Reform Act* 1998 (Vic) s 22; *Retail Shop Leases Act* 1994 s 50; *Retail and Commercial Leases Act* 1995 (SA) s 43; *Commercial Tenancy (Retail Shop) Agreements Act* 1985 (WA) s 10.

63 [1990] VR 646.

condition precedent to refusal of consent by the lessor to subletting (or the approval of improvements), that the lessor acts in good faith. On the strength of this, the lessee claimed relief against forfeiture after the lessor attempted to forfeit the lease on the ground of those alleged breaches.

Effectively, the lessee was endeavouring to overcome the express exclusion of statutory expression of reasonableness by refusing consent to the subletting in urging the court to imply that the refusal of consent must be exercised in good faith.

In view of the lawful, express exclusion of the reasonableness provision which may have otherwise precluded the lessor from unreasonably refusing consent to appropriate sublettings, McGarvie J found that it would not be correct to imply a term which under another "legal label" would partially reapply that exclusion.[64] However, in respect of the withholding of approval of materials, plans, specifications and designs for improvements, particularly with a view to forcing the lessee to vary the lease in relation to rent, his Honour was not so constrained by any statutory provisions. Accordingly, he was prepared to hold that a term should be implied in the lease that the lessor could not unreasonably withhold approval for the construction of improvements in the building, as the refusal would be held to be unreasonable given the motive of the lessor.[65] In this case, McGarvie J did not imply a term that approval must be exercised "in good faith" as he found that the expression "too vague." Instead, he implied a term of "reasonableness" which he said was a "tried and reliable and working tool in the law of contract".[66]

Given the development of law relating to the implication of the term of good faith since that decision, in August 1989, a refinement in the idea of "good faith" now means more than mere reasonableness. Current formulations of the concept of "good faith" may have strengthened this lessee's hand in respect of the refusal to

64 Ibid at 653.
65 Ibid at 667.
66 Ibid.

consent to the subletting based on the lessor's improper motive.[67] However, given the admitted subtleties in the differences between the concepts of "good faith" and "reasonableness", could it now be possible to withhold consent unreasonably, but still be acting fairly and honestly? Where there is an improper motive of either party that can be proven, as in this case, can a party still be acting either reasonably or in good faith?[68]

(b) Termination under a break clause

A break clause is incorporated in a lease to permit the lessor (usually) to terminate a lease upon a specified period of notice, prior to the expiration of the term for some particular purpose stated in the lease, usually refurbishment, renovation or demolition. These clauses are sometimes known in Australia as "demolition" clauses. Generally, where a lessor gives such a notice, it must be on the basis that the lessor has a bona fide intention of pursuing that course which was the stated reason given in the notice. The notice must be given in conformity with the right to give it under the lease.[69] In *Blackler v Felpure Pty Ltd*,[70] a clause in a lease permitted a lessor to terminate the lease upon six months notice where the lessor wanted to "repair, renovate or demolish the premises." Being a retail shop lease, s 35 of the *Retail Leases Act* 1994 (NSW) applied to the notice. This section recognised a right in the lessor to terminate a lease on the grounds of proposed demolition of the building in which the retail shop was situated, but only if the lessor had provided the lessee with details of the proposed demolition sufficient to indicate a genuine proposal to do so and subject to certain other conditions. At a time when the lessee had just exercised an option to renew, the lessors had been negotiating to sell the shopping centre to purchasers. Upon the purchasers'

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67 In *JA McBeath Nominees Pty Ltd v Jenkins Development Corporation Pty Ltd* [1992] 2Qd R 121, a lessor was held to have unreasonably refused consent to an assignment with a view to forcing a surrender of the lease which was held to be an improper motive.

68 Compare, for example, the effect of proof of the improper motives of an assignee of a lease where refusal of consent to an assignment was held to be reasonable: *Pimms Ltd v The Master, Mordens and Commonalty of the Mystery of Tallow Chandlers in the City of London* [1964] 2 QB 547 at 572.

69 *Southend-on-sea Estates Co Ltd v Inland Revenue Commissioners* [1914] 1 KB 515 at 524; affirmed [1915] AC 428.

70 (2000) 9 BPR 17, 257.

becoming the owners, the purchasers argued that the option had not been validly exercised. They purported to terminate the lease on the basis of their plans to renovate the building and required vacant possession to do so. In fact, they were planning to replace the lessee's premises with offices from which they (the purchasers) could conduct their business.

The lessee challenged the right to terminate to terminate the lease, particularly on the ground that the underlying basis of the termination was to put another occupant in possession and not to renovate the premises. Bryson J found, as a fact, that the lessor was genuinely planning to renovate the premises. This provided a sufficient reason to give the notice of termination which, subject to s 35 of the *Retail Leases Act* 1994, was an entitlement of the lessors' under the lease. Bryson J said

> "The opportunity to break a lease, retake possession and take advantage of a demolition clause is a contractual opportunity made available to the lessor by the terms of the lease itself… it is not injurious to the lessors' position whether the lessor has decided to take that advantage and it is not relevant that the lessor has in view occupying the premises itself or selling them after reconstruction or leasing them again, even if the lease should be to business similar to the lessee's. The demolition clause is a reality of the parties relationship and so is its potential to end the lease".[71]

This decision illustrates that a lessor may exercise a contractual right to his or her own advantage and not show lack of good faith. Here, the lessor did have a proposal within the meaning of the clause giving the right to terminate. It is note worthy that Bryson J indicated that he may have regarded the question more seriously if there had not been a genuine proposal to renovate. This may have shown evidence of a lack of good faith in dealing with the lessee. Commenting on this decision, Eileen Webb[72] says that the judgment appears to make commercial sense and that the lessor was entitled to make a commercial decision in its own interests and not on an altruistic basis.[73]

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71 Ibid at 17, 271.

72 "Break Clauses, Self Interest and Notions of Good Faith" (2000) 8 Australian Property Law Journal 175.

73 Ibid at 178-179.

Even given the developments in the law relating to the implication of an obligation to exercise powers and good faith, a lessor who gave notice under a break clause, where the notice could only be given for specified purposes, and where those conditions had not been met, there is little doubt that the lessee could challenge the notice.[74] It is also worthy of note, and mentioned by Webb,[75] that s 51 AC of the *Trade Practices Act* 1974 might well render the lessors conduct unconscionable in these circumstances. One of the elements of unconscionability to which the court might have regard is the lack of good faith.[76]

(c) Insistence by lessor on lessee meeting lawful requirements of legislation

The case of *Alcatel Australia Ltd v Scarcella*[77] provides an interesting instance of an attempt by a lessee to temper compliance with a clause of a commercial lease for 50 years which required the lessee to observe lawful requirements of all Acts and regulations, and to execute work as required by that legislation indemnifying the lessor against claims in respect of liability in default of the lessor doing so. Briefly, lessors commissioned a fire safety report which found a number of deficiencies in the demised premises and sought a fire safety inspection from the local authority. As a result, the local authority issued a list of requisitions necessary to meet the fire safety requirements. At some time, these were passed on to the lessee with the request that they would be responsible for the work under the terms of the lease. About a year later, with no action having been taken by the lessee, the local authority intimated that it proposed to issue an order to the lessors requiring the work to be done, and, in fact, this occurred. The lessee found the requirements onerous but, under the *Local Government Act* 1993 (NSW) as then amended, only the owner could appeal against the order. Briefly, the lessee claimed that because the lessor had effectively pressured the local authority into imposing stricter and unreasonable fire safety requirements, the lessee was not obliged to comply with the

74 *Parkinson v Barclays Bank Ltd* [1951] 1 KB 368.
75 "Break Clauses, Self Interest and Notions of Good Faith", op. cit., 179.
76 *Trade Practices Act* 1974 (Cth) s 51AC(3)(k).
77 (1998) 44 NSWLR 349.

covenant in the lease which effectively made the lessee responsible for making good the requisitions. The lessee argued that it was an implied term of good faith or reasonableness required by the lessors in the performance of their obligations which bound the lessors to co-operate in a reasonable way to ensure that the lessee was not subjected to the expense of an unreasonable fire order.[78] The court found that, in these circumstances, the duty could be implied as part of the lease. However, the lessee failed to demonstrate that the requirements of the fire safety order were unreasonable. On behalf of the Court of Appeal, Sheller JA concluded:

> "In a commercial context, it cannot be said, in my opinion, that a property owner acts unconscionably or in breach of an implied term of good faith in a lease of a property by taking steps to ensure that the requirements for fire safety advised by a fire engineer should be put in place. It was… the contractual duty of the (lessee) to observe and perform the requirements of the council, if lawful, and to do and execute or cause to be done an executed such works as were required by the council. The (lessors) had a legitimate interest in ensuring that the building was properly protected… I can see no reason why (the council) should not press for more stringent requirements".[79]

In commentary on this decision, Elisabeth Peden, correctly, in my view, states that it was completely unclear as to what method was used by the court to achieve result of the implication of an obligation of good faith in this case.[80] Several conclusions may be drawn from this decision. Firstly, the lessor was acting within its legitimate rights to seek a fire safety report and a local authority inspection of the premises to ascertain whether the premises met fire safety requirements. Indeed, it was in the public interest that they do just that. Secondly, the lessors had every right under the lease negotiated at arms length, to pass on the cost and expense of these requirements to the lessee. Thirdly, the lessor had a right not to appeal the stringency of the requirements, regardless of the fact that the lessee may have considered the imposition of these requirements unreasonable. The consequence of contrary decision may have left the law in this regard a very unsatisfactory state.

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78 Ibid at 363.

79 Ibid at 369-370.

80 Elisabeth Peden, "Incorporating Terms of Good Faith in Contract Law in Australia", op. cit., at 226.

Although the court undertook a significant examination of the law relating to implied terms of good faith, particularly in New South Wales, there are no express reasons given by the court why the term should be implied in leases. One presumes that inferentially, leases are being treated as contracts. On the other side of the coin, it is the duty of the lessee to satisfy itself as to the physical fitness of the premises for the purposes for which they are let. Such a term would be implied if it were not expressed.[81] One could argue that a lessee taking a lease for 50 years might well concern itself with making financial provision for changes in fire safety requirements, knowing that the cost of any changes may well be sheeted home to that lessee over such a lengthy period.

(d) An implied term that the lessor will do all in its powers to co-operate and permit the lessee to effect certain works upon the premises

The decision of *Advance Fitness v Bondi Diggers*[82] raises a novel point which impacts upon whether or not an implied term in the form of an obligation to co-operate might be implied in an express lease. This obligation is closely allied to the good faith obligation. Under a commercial lease, a commercial building, constructed in the 1960s and 70s was demised to the lessee for ten years from 1991 with an option for a further ten years. During the first term, fire safety requirements for such buildings became more onerous and the local authority, during the period of the lease, served a notice on the lessor requiring certain extensive building work to be undertaken to meet the new fire safety requirement. The lessor was then the head lessee rather than owner of the building, but successfully exercised an option to purchase the building in 1995 with a view to redevelopment of the building as residential apartments. To permit this project to proceed, the lessor (then as owner) required vacant possession of the lessee's premises. The local authority deferred action on the notice until early 1998 when these arrangements had been clarified. However, by August 1998 the local authority made a further order requiring the lessor to address the deficiencies with respect to fire safety, including attention to

81 *Bradford House Pty Ltd v Leroy Fashion Group Ltd* (1983) 68 FLR 1 at 8-9.

82 [1999] NSWSC 264.

structural aspects of the building. As the lessor wished to redevelop the property, it was loathe to expend funds in this way. When the lessor did not comply with an order (in the first instance to submit plans) the local authority in October 1998 issued an order requiring evacuation of the premises within 60 days. The lessee became aware of the requirements sometime before this and had contacted the local authority. The lessor, however, did nothing and welcomed the evacuation order to secure vacant possession of the building. After much negotiation, and an attempt by the lessor to lock out the lessee, the lessee sought an order that the lessor provide its consent to the local authority for the lessee to carry out the fire safety works required as a condition for the lessee to remain in occupation. Under the existing sublease, the lessor was under an obligation to undertake structural work (which was necessary to meet part of the requirements) and the lessee was under an obligation to complete the balance of the work. Essentially, the lessee's case was that the lessor was obliged to co-operate to permit the lessee to effect the work at its option and expense or at least, not to refuse to co-operate unreasonably for extraneous purposes to achieve early vacant possession. The lessor denied that there was any express or implied obligation requiring it to carry out the work and, alternatively, if there was, it could not be unqualified, and must be in a form in which the lessor retained a discretion whether or not to consent to the works being done.

The court then had to determine whether or not in this specific instance, an implied obligation of good faith or fair dealing arose in this lease and, if so, whether or not the lessor was in breach of this. There was little doubt, from the evidence, that the lessor wished the lessee to vacate and had a strong commercial incentive to do so. Secondly, it was clear that if the work was not permitted to be carried out because of the lack of co-operation of the lessor, the lessee would have to vacate.

Austin J refused to imply a term that the lessor had an obligation to co-operate or imply a term that the lessor exercise the contractual power to refuse reasonably or in good faith. The reason for this, his Honour said, was because compliance with

the fire safety requirements "cannot be classed as something the parties have agreed shall be done". Effectively, as his Honour found, the express terms of the lease dealt with the rights and obligations of the parties with respect to repairs and compliance with requirements of statute. There was no room for implication of a term.[83] Austin J also found no room for the application of any obligation of fair dealing or good faith or reasonableness as he did not regard the lessor's conduct in the commercial context as inconsistent with this duty. This finding went hand in hand with a finding that the lessor engaged in conduct designed to make it difficult for the lessee to carry on business in the demised premises and acting with a view to securing vacant possession of the building for its own purposes.[84]

This view is legally consistent with that of Waddell J in an earlier decision of *Brilee Consultants Pty Ltd v Tibal Holdings Pty Ltd*[85] where the court would not imply an obligation upon a lessor to require the lessor to comply with a notice from the local authority with respect to fire safety on the basis of some implied obligation of the lessor to keep the demised premises fit for occupation. In the lease, the subject of this litigation, the lessor expressly did not warrant the demised premises would remain suitable or adequate for the purposes of the lessee. Accordingly, there could be no implied warranty which had the effect of negating the force of that express clause, regardless of how that implied obligation might be cast.[86]

The decision of *Advance Fitness v Bondi Diggers*[87] in this context suggests strongly, that where ground is covered effectively by the written agreement between the parties, there will be little room for implied terms, whether this implied term is to co-operate or an implied obligation of good faith. Commercial leases are, of themselves, usually lengthy documents which cover the field and those types of agreements where terms are less likely to be implied than perhaps than in other types of agreements. Secondly, just because the lessor was found to be "guilty of

83 Ibid at [121].
84 Ibid at [122].
85 (1984) 3 BPR [97184] 9272.
86 Ibid at 9,274.
87 [1999] NSWSC 264.

improper commercial conduct",[88] there is no automatic implication that the lessor had breached an implied obligation of good faith. In the words of Austin J:

> "… fairness does not require that, in all circumstances of this case, (such) misconduct should entitle the (lessee) to compel the (lessor) to consent to substantial work which it does not wish to have done to the building which it owns – nor, in my opinion, does the law."[89]

Further, as noted by Elisabeth Peden, addressing this point in her article,[90] the implication of this term was not necessary for the business efficacy of this lease. The parties were entitled to perform their obligations in their own interests. The net effect of this decision meant that the lessor did not have to consent to substantial building work on the premises as required by the fire safety order and, accordingly the work not being done, the lessee was bound to vacate the premises, thus giving the lessor the green light to redevelop free of the lease.

Would the Implication of a Term of Good Faith in Commercial Leases usually be Necessary?

As previously suggested in this article, commercial leasing arrangements between lessor and lessee are already highly regulated, particularly so in the case of retail shop leases.[91] The few cases in the area of good faith in commercial contracts tend to suggest that obligations of good faith and reasonableness are more readily implied in standard form contracts, particularly if such contracts contain a general power of termination but the implication is not limited to these forms of agreement.[92] Most commercial leases, however, are not what could be called standard form agreements and many, in fact, are unique, either to the particular demised premises or to the actual commercial complex.

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88 Ibid at [128].

89 Ibid.

90 Elisabeth Peden, "Incorporating Terms of Good Faith in Contract Law in Australia" op. cit., at 228.

91 See footnotes 51 and 52.

92 *Burger King Corp v Hungry Jack's Pty Ltd* (Supreme Court of New South Wales, Court of Appeal, 21 June 2001, Sheller, Beazley and Stein JJA) at [163].

Clearly, the most significant power enjoyed by a lessor vis a viz a lessee, is the power of termination of the lease where the lessee is in breach. In practice, a lessor will invariably reserve himself or herself the right to terminate a lease and a right to re-enter and forfeit the estate where the lessee is in breach of any term of the lease. This right of termination my be exercised whether or not the term breached is essential or non-essential, or put another way, whether its breach would attract substantial damages or nominal damages.[93] This power of re-entry, which had to be expressly reserved by the lessor, was treated in equity as security for the payment of rent.[94] As a rule, equity would relieve against the forfeiture of a lease upon the payment of rent, and likewise, will generally relieve against forfeiture where any other breach relied upon is not essential and where satisfactory arrangements have been made for the breach to be remedied.

Legislation now recognises the consequences of termination for breach by providing in various states that a lessee be given a statutory notice to remedy breach within a reasonable time before a right of re-entry might accrue for the breach.[95] It is common ground that Australian courts regulate the operation of general rescission clauses by preventing their use for improper and extraneous purposes.[96]

The right to grant relief against forfeiture maybe generally granted on such terms as to costs, damages, compensation, penalty or otherwise as the court think fits.[97] In considering whether or not to grant relief, a court will look at the entire circumstances of the alleged breach including the general conduct of both lessee and lessor, the seriousness

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93 *Shevill v Builders' Licensing Board* (1982) 149 CLR 620-629 Gibbs CJ.

94 *Howard v Fanshawe* [1895] 2 Ch 581 at 588; *Ezekiel v Orakoko* [1977] QB 260 at 268-269.

95 *Conveyancing Act* 1919 (NSW) s 129(1); *Property Law Act* 1958 (Vic) s 146(1); *Property Law Act* 1974 (Qld) s 124(1); *Landlord and Tenant Act* 1936 (SA) ss 9, 10; *Property Law Act* 1969 (WA) s 81(1); *Conveyancing and Law of Property Act* 1884 (Tas) s 15 (1).

96 *Godfrey Constructions Pty Ltd v Kanagra Park Pty Ltd* (1972) 128 CLR 529 at 548; *Pierce Bell Sales Pty Ltd v Frazer* (1973) 130 CLR 575 at 587 per Barwick CJ.

97 *Conveyancing Act* 1919 (NSW) s 129(2); *Property Law Act* 1958 (Vic) s 146(2); *Property Law Act* 1974 (Qld) s 124(2); *Landlord and Tenant Act* 1936 (SA) ss 9 (1), 11 (1) and (2); *Property Law Act* 1969 (WA) s 81(2)(b); *Conveyancing and Law of Property Act* 1884 (Tas) s 15(2).

of the breach, whether the breach can be easily remedied and whether compensation might be an adequate remedy rather than forfeiture.[98]

This is but one example of the wide variety of statutes that enable a court to review the behaviour of parties to a commercial agreement and to give relief to an aggrieved party. The existence of these statutory provisions, and particularly those in the *Trade Practices Act* 1974 relating to unconscionability[99] was recognised in the landmark decision on good faith, *Reynard Constructions (ME) Pty Ltd v Minister for Public Works*[100] in the principal judgment of Priestley JA.[101] It could therefore be argued, particularly in relation to the termination of leases, that the principles of equity which might properly govern the party's conduct are now embodied in statutory form and more than adequately permit a court to review misconduct and grant relief where appropriate. The existence of such statutory provisions rather negates the necessity for a court to imply terms of reasonableness and good faith in considering these issues, especially in the context of default, however that arises.

This very point was taken up by Gummow J in *Service Station Association Ltd v Berg Bennett & Associates Pty Ltd*[102] where he expressed his view in the following terms:

> "Equity has intervened in matters of contractual formation by remedy of rescission, upon the grounds mentioned earlier. It has restrained freedom of contract by inventing and protecting the equity of redemption, and by relieving against forfeiture and penalties. To some extent, equity has regulated the quality of contractual performance by the various defences available to suit for specific performance and for injunctive relief. In some, but not all, of this, notions of good conscience play a part. But it requires a leap of faith to translate these well established doctrines and remedies into a new term as to the quality of contractual performance, implied by law."[103]

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98 See generally *Hyman v Rose* [1912] AC 623 at 631 per Earl Loreburn LC (HL); *Shiloh Spinners Ltd v Harding* [1973] AC 691 at 725-726 per Lord Wilberforce (HL).

99 For example, ss 51 AA, 51 AC.

100 (1992) 26 NSWLR 234.

101 Ibid at 268.

102 (1993) 45 FCR 84.

103 Ibid at 96.

This dictum has been seen as too narrow.[104] However, that decision was not dealing with a commercial lease.

Putting aside the question of good faith in the exercise of powers of rescission, it should be noted that two significant decisions, *Alcatel Ltd v Scarcella*[105] and *Advanced Fitness v Bondi Diggers*,[106] concerning commercial leases and the obligation of good faith were not cases on the implication of that term in exercising a power of termination. Rather, in both of these cases, the lessees were seeking sympathetic treatment by their respective lessors with respect to the interpretation of clauses in the respective lease relating to the extent of repair which was their express responsibility generally under the leases. Both lessees failed largely because the lessors were not doing anything contrary to the express terms of the lease to which the lessees had agreed. Interestingly though is the comment of Austin J in *Advanced Fitness v Bondi Diggers*[107] in respect of the lessor's position when, in his concluding remarks, he said that:

> "it may initially seem to be unfair that the plaintiffs (lessees) case fails, even though I have found officers of the defendant to be guilty of improper commercial conduct".[108]

Similarly, in the case of *Australian Mutual Provident Society v 400 St Kilda Road Pty Ltd*,[109] in respect of refusal of consent to the subletting, the lessor was held to have a right to unreasonably refuse as the operation of Section 144 of the *Property Law Act* 1958 (Vic) had been legally excluded. It naturally would have been inappropriate for a court to imply terms which a party had an express right to exclude. However, whilst McGarvie J was not prepared to disturb that decision of the lessor, he was prepared to hold, unconstrained by that statute, that the lessor had unreasonably withheld approval for the erection or construction of improvements to the building. In this, there was evidence of improper motive of the lessor forcing the lessee to agree to vary the terms of the lease

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104 For example, see *Hughes Aircraft Systems International v Air Services Australia* (1997) 146 ALR 1 at 37 per Finn J.

105 (1998) 44 NSW LR 349.

106 [1999] NSW SC 264.

107 [1999] NSW SC 264.

108 Ibid at para [128].

109 [1990] VR 646.

and not referrable to the substance of the decision.[110] As previously stated, in respect of rights of assignment, which are generally qualified by statute, on improper motive in giving the refusal will found relief in the lessee.[111] Where a lessor has a discretion and it is not constrained by statute, a refusal may be unreasonable and lawfully so.[112]

Conclusion

In conclusion, it is submitted that, given the extent of coverage of bargain that is usually express in a commercial lease, and given the statutory protections already available to a lessee to challenge the conduct of a lessor, there may only be a small area of operation left for the operation of the implied term of good faith. However, as can be seen from the relevant cases, where a lessor is merely protecting his or her legitimate interests and where a clause in the lease adequately covers the situation, although a lessor may be acting in a morally offensive manner, this conduct will have no legal implications for the lessee. In future, lessees' cases may be strengthened if the parties mutually covenant in the lease itself that they will, throughout the term of the lease, exercise good faith in the conduct of their relationship. The rules of construction would then ensure that every express obligation was undertaken and every discretion exercised, subject to that condition. However, in the absence of an express term, in appropriate circumstances, s 51AC(3)(K) of the *Trade Practices Act* 1974 may well come to the aid of an aggrieved lease.

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110 Ibid at 673.

111 For example, *Bromley Park Garden Estate Ltd v Moss* [1982] 1WLR 1019 at 1027; *Noyes v Klein* [1984] 3 BPR/9216 at 9230 per Kearney J.

112 *Re Archos* [1994] 1 QdR 223; *Barina Properties Pty Ltd v Bernard Hastie (Australia) Pty Ltd* [1979] 1 NSW LR 480 at 486-487 (cases where lessor held to be acting appropriately where refusing consent to a change in the use).